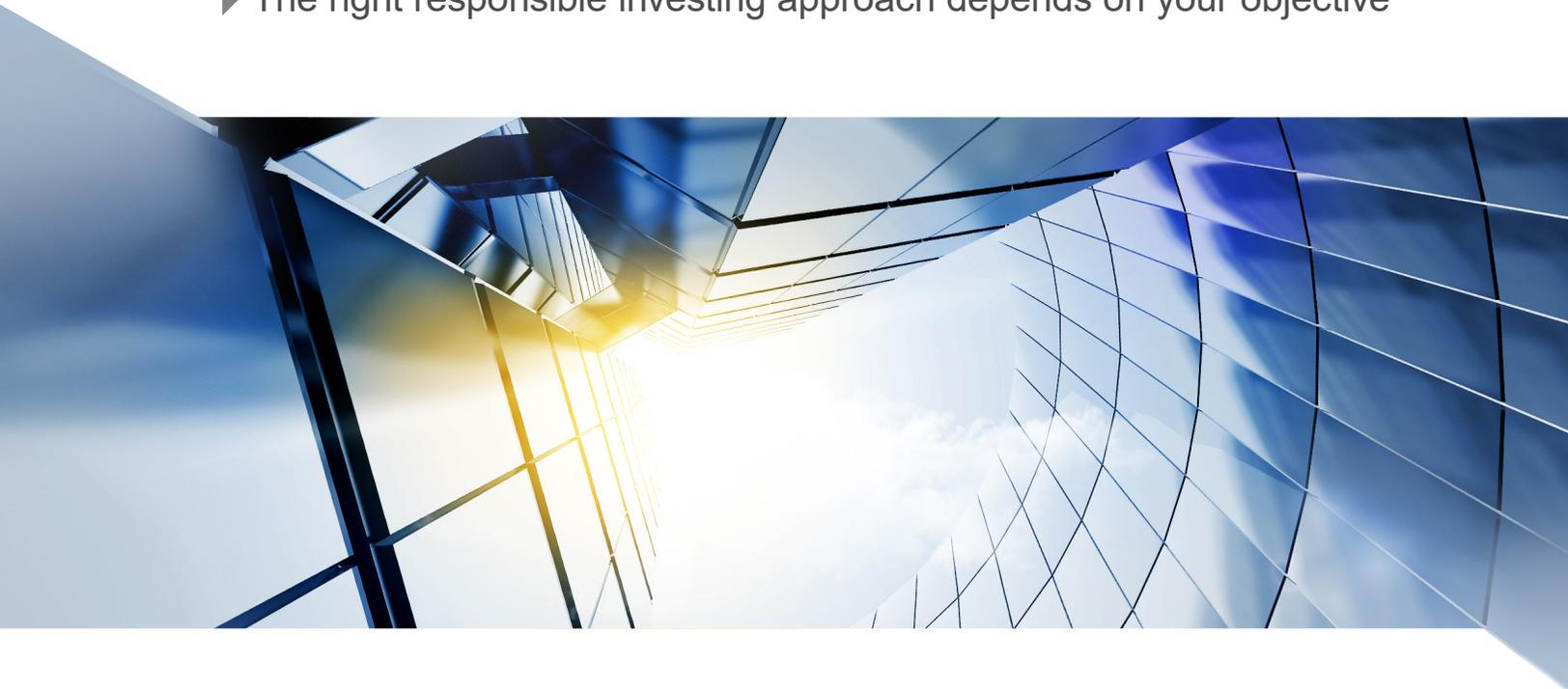


Engagement vs. Divestment

► The right responsible investing approach depends on your objective



Over the past few years, responsible investing (RI) has become mainstream in the investment world, as investors want to ensure the money they are investing is not contributing to societal harm. Yet, despite the progress that has been made in integrating RI into mainstream portfolios, there remains a ‘tug-of-war’ of sorts between two basic approaches to managing such portfolios. The first concept is that of selling a company whose products or practices you don’t agree with – Divestment. The second is Engagement – the idea that more progress can be made by speaking with corporate leaders to encourage positive change. This article will outline the arguments for both approaches and, ultimately, why we, at Guardian Capital LP, believe that Engagement can more effectively enact the societal changes that responsible investors want to see.

Divestment

Divestment is easy to understand at face value. Selling a stock that is disagreeable to your values seems like a common sense approach. One can have sympathy for a doctor, for example, not wanting to own a tobacco company in their portfolio. As a physician, they have witnessed the suffering caused by these products and they would correctly argue that no amount of negotiation with such companies could convince corporate leaders to change the essence of what they are – a tobacco company.

The categories of potential divestment are as varied as the values that lead to such decisions.

Divestment is not a new concept. Its roots trace back to religious groups in the 1700s shunning “sin” stocks (alcohol, gambling, weapons, tobacco, slavery and more). From the 1960s to the 1980s, the anti-South African, anti-apartheid movement asked investors to divest of any company dealing with that country. Fast forward to today – divestment campaigns have expanded to include a wide variety of values-based issues, such as nuclear energy and adult entertainment – and the categories of potential divestment are as varied as the values that lead to such decisions.

Also common today are divestment campaigns that ask large asset owners to sell stocks or companies of entire “undesirable” industries. These are similar to consumer boycotts of products but, rather than an effort to abstain from buying a product, efforts are made to encourage large asset owners, such as pension funds or endowments, to exclude a specific industry.

One of the most well known of these divestment campaigns today is [350.org](https://www.350.org). This movement was founded in 2008 and sought to ‘encourage’ asset owners to divest of fossil fuels in order to keep carbon dioxide below 350 parts per million in the atmosphere.¹ This campaign was most prevalent on university campuses, with proponents arguing that engaging with management is too slow of a process and that action on climate change is needed now.

The challenge with divestment

If an investor cares about producing positive environmental or social change, selling a company could be seen as leaving the responsibility of driving change to someone else.

The biggest argument against divestment is that, even if an investor does not like what a company is doing, selling the company will have no impact on reducing societal harm. The old stock market adage is that for every buyer there is a seller, and conversely for every seller there is a buyer. If investors who are concerned about a company’s environmental, social, and governance (ESG) practices sell the company, it may well end up in the hands of an investor who cares less about those same ESG issues. In essence, selling a company could be seen as leaving the responsibility of driving change to someone else.

One of the earlier arguments for divestment was that such actions in a public company would help to starve these organizations of capital. Most public companies routinely issue shares to raise equity, or raise capital in the bond market to help fund corporate initiatives. This approach argues that if a company were to be labelled an ESG offender, it might turn off the taps to such capital-raising efforts. Such arguments are rarely heard today, as it has become obvious that these threats are empty because of the depth and breadth of capital markets. Despite numerous studies, there is almost no evidence that there is any clear link between targeted divestment campaigns and difficulty

accessing capital – either through increasing costs or decreasing access – even for companies in “undesirable” sectors. Regardless of how unsavoury a company may be to some investors, there always seems to be another investor willing to put forward capital.

An article in The Economist magazine sums this up nicely.

“The Western world’s dirty assets are heading into the shadows. Public firms, including European oil majors such as Shell, and large listed mining outfits, are selling their most polluting assets in order to please ESG investors and meet their carbon-reduction targets. But those oil wells and coal mines are not being shut down. Instead they are being bought by private companies and funds that have alternative sources of capital and stay out of the limelight. Little wonder: owning dirty assets may require a thick skin, but it is likely to be profitable. Private-equity firms have snapped up \$60bn-worth of fossil-fuel-linked assets in the past two years alone, from shale fields to pipelines.” (The Economist, “The truth about dirty assets”, February 12, 2022) .

In other words, to encourage investors to not sell their stock, certain oil and gas or mining companies, for example, are dumping problem assets into the willing hands of others, but nothing really changes from an emissions standpoint. Clearly, a different approach is required.

Serious ESG investors have done the math with regards to divestment. Even in undesirable sectors or industries, there will always be other investors who do not care about ESG issues. With this backdrop, if the goal is to address climate change and reduce carbon emissions, then the best approach is one that prevents companies from dumping high-emission operations and assets into the hands of the uncaring – and instead acting like an owner and engaging with corporate leaders.

Engagement shows demonstrated results

Shareholders can use their power to influence corporate behaviour through engagement.

The flipside to divestment is Active Ownership, in which shareholders use their power, guided by ESG considerations, to influence corporate behaviour through engagement with senior management and corporate boards, as well as through proxy voting.

Engagement has become common practice among institutional investors and involves undertaking a series of meetings with corporate leaders to understand and question current practices and to encourage positive change. This approach recognizes that change to a large organization with built infrastructure and entrenched industry practices can take time and that ongoing engagement and collaboration are critical. The simple idea behind engagement is to be ‘top of mind’ with corporate leaders when they make business decisions.

Consider a simple scenario: Institutional investors routinely meet with corporate leaders in one-on-one and conference settings. Traditionally, these meetings have focused on business strategy and the financial results and outlook; however, many investors now routinely ask about the ESG risks and opportunities specific to the company – for example, how the company is measuring and disclosing greenhouse gas emissions. The company’s response to any specific issue may not be immediate, but if there is persistency to these appeals, the company will likely address the issue and/or provide the requested data. The next round of meetings might focus on asking the same company to explore more aggressive ways to reduce emissions. Perhaps a third iteration would be asking the company to incentivize senior management to reduce emissions by including ESG targets as part of compensation. Through this process of engagement, continual progress is made towards better ESG practices and results.

Similarly, by exercising their proxy voting rights, shareholders are able to influence companies by electing more ESG-oriented board members or voting for shareholder proposals that require the company to take more action in either disclosing or setting goals for ESG matters like carbon emissions or diversity targets.

By applying this concept to the fossil fuel industry – one that has increasingly been targeted by divestment campaigns – advocates for Active Ownership see it as a tool that will help push oil and gas companies to become greener, faster.

For example, Canada’s largest fossil fuel producer, Suncor, is part of a group of Canadian oil and gas companies that has committed to achieving net-zero emissions status by 2050¹ by investing heavily in new technologies. This move is significant for an energy producer – with a price tag that will likely be in the billions. One can only wonder if this would have ever come about if all investors who were unhappy about greenhouse gas emissions simply sold their holdings into the hands of investors who were solely profit-oriented. It is reasonable to assume that, in part, this change came as a result of years of engagement.

Engagement enables companies to be part of the solution – not just part of the problem

Engagement leverages the company's expertise to address the issue.

Incumbent companies are often best placed to affect change in an industry because they have the deepest experience and capability to understand and address complex issues. In addition, they are highly incentivized to do so in order to ensure their own long-term survival.

There are industry leaders and laggards when it comes to sustainability. Returning to the energy industry – ESG leaders in this space have been proactive in addressing ESG issues, have strong track records on operating ethically and are focused on reducing carbon emissions and developing a path to net zero. In Canada, a group of leading oil and gas companies established the “[Oil Sands Pathways to Net Zero](#)” Alliance. This group, which represents 90% of Canada’s oil sands production, will work with the federal and provincial governments, and has laid out a credible plan to achieve net-zero greenhouse gas emissions from its members by 2050.² The plan follows a three-phase approach and recognizes that multiple parallel pathways are needed to achieve the goal – it addresses numerous areas, including electrification, fuel substitution, energy efficiency, carbon capture, process improvements and the implementation of emerging technologies.

This approach recognizes that oil and gas companies, with their long operating history and strong research and development (R&D) track record, are well placed to further develop existing technologies like carbon capture and storage technology. In addition, they can invest in and advance R&D on new technologies and solutions like hydrogen or small modular nuclear reactors, as well as emerging technologies like direct air capture. Many of these oil and gas companies have been engaging with investors on sustainability for years, and this engagement has led to constructive dialogue and a progressive approach by both sides.

No silver bullet – tackling real-life issues is complex

Deeper understanding and considerations are needed to address real-life situations.

Another drawback of divestment is that it is often too simplistic of an approach to effectively address complex real-life situations. It is becoming increasingly difficult to categorize companies as “good” or “bad” purely on the basis of the sector in which they operate.

For example, the renewable energy sector is generally viewed as having favorable ESG characteristics, but digging a bit deeper uncovers that the sector faces its share of controversial issues. A November 2021 report published by The Business & Human Rights Resource Centre, an international corporate watchdog, has found over 200 allegations of serious human rights violations. These include land grabs and violations of the rights of Indigenous nations in the renewable energy sector, with 44% of these allegations connected to the wind and solar sectors.³ Another example relates to the sourcing of polysilicon, a key component in solar panels, from the Xinjiang region in China which is allegedly using the Uyghur minority group as forced labour.⁴ This region currently supplies 80% of the world’s polysilicon, and the ability to trace components back through the supply chain is limited. Renewable

companies involved in solar development are actively trying to address these issues, but finding solutions will take time. A straight divestment approach, which penalizes these companies for their involvement – even indirectly through their supply chain – in potential human rights abuses would not only fail to help solve the issue, but could also delay or impede much needed growth in renewable energy production.

Similarly, developers of electric vehicles (EVs) have benefitted because EVs are widely believed to be more environmentally friendly than internal combustion engine (ICE) vehicles. However, the lifetime carbon emissions footprint of an EV depends largely on the source of energy used in manufacturing the car. In regions which use coal-fired energy for manufacturing – such as China or India – the overall lifetime carbon emissions of EVs can actually be higher than for ICE vehicles. Furthermore, some of the key components needed to make EV batteries (lithium and cobalt) are found primarily in countries like the Democratic Republic of Congo, which are plagued with human rights abuses. In addition, an environmentally friendly solution to the disposal of expired car batteries has yet to be found. Again, companies involved in this industry are working hard to discover solutions to these issues, but this will take time, and a straight divestment approach will not directly help with this objective.

These are just some examples which serve to emphasize that ESG concerns such as addressing climate change and the energy transition are extremely complex; even industries or companies that seem “green” on the surface have their share of ESG issues to contend with, and the path to ultimately get us to a lower carbon and more socially responsible world must be carefully considered. Simply selling a stock in a fossil fuel producer seems like a blunt instrument to a complex problem.

Can divestment and engagement work together?

Investors can utilize engagement and divestment together to drive change.

Even though engagement takes a more thoughtful approach to enacting change than divestment does, it can also face issues. While most companies willingly engage with investors to improve their ESG profile, there are some companies who do not. What should an investor do if a company is not willing to engage with investors or does not sufficiently address the ESG risks and considerations facing its business?

As with many things, the best solution is not binary when it comes to the debate between engagement and divestment. Recent studies⁵ have shown that these approaches should not be mutually exclusive, and that the best results come from a combination of the carrot (engagement) and the stick (divestment). Many institutional investors have escalation

strategies in place to further the conversation with companies that are either not addressing their concerns or moving slower than desired. Without the threat of ultimately divesting if the company does not change its behaviour, some believe that investors have no leverage when employing an engagement-only approach. Having a stick is a way to incentivize the company to embrace the carrot, and as a result, the efficiency of each is reinforced by the other.

Ultimately, while pure divestment might be the right approach for certain values-based investors, we view engagement as a more effective approach when the goal is to influence corporate behaviour and enact societal change. Within the context of an engagement approach, divestment can be used as a tool in escalation strategies. Yet with the complexities of real-life scenarios, investors need to be thoughtful when determining the best approach to bringing the world towards the change we all want to see.

¹ *About 350*, 350.org, accessed January 10, 2022, <https://350.org/about>.

² *Oil Sands Pathway to Net Zero, Helping Canada achieve its climate goals*, accessed January 10, 2022, <https://www.oilsandspathways.ca>.

³ Business and Human Rights Resource Centre, *Renewable Energy & Human Rights Benchmark 2021*, Briefing November 2, 2021. <https://www.business-humanrights.org/en/from-us/briefings/renewable-energy-human-rights-benchmark-2>.

⁴ Murtaugh, D., with C. Murphy, J. Maygar and B. Eckhouse, *Secrecy and Abuse Claims Haunt China's Solar Factories in Xinjiang*, Bloomberg Green, Bloomberg, L.P., (April 13, 2021). <https://www.bloomberg.com/graphics/2021-xinjiang-solar>.

⁵ Amenc, N. and Christiansen, E., Esakia, M., & Goltz, F., *ESG Engagement and Divestment: Mutually Exclusive or Mutually Reinforcing?*, A Scientific Beta Publication, May 2020. <https://www.scientificbeta.com/download/file/esg-engagement-and-divestment>.

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